

3. THE CZECH REPUBLIC

Strong labour market and steady GDP growth

The economy of the Czech Republic continues to grow at a steady pace, while inflation has returned to target after three subdued years. The labour market is strong, but employment growth is likely to slow markedly after 2017. The abandonment of the exchange rate policy by the central bank raises risks but is unlikely to have a material short-term impact on the economy. The headline surplus in 2016 reached 0.6% of GDP but the surplus is expected to decline in 2017 and 2018.

Stable growth ahead

The economy of the Czech Republic is forecast to grow by 2.6% in 2017, slightly above the 2.4% rate in 2016 and somewhat above its estimated long-term potential. In 2017, the main contribution to GDP growth is expected to come from domestic demand. Private consumption growth of 2.4% is likely to act as a key driver, supported by a booming labour market and buoyant consumer confidence. While rising inflation will dent real incomes, the impact on spending is expected to be partly counteracted by a fall in the household saving rate. Gross fixed capital formation is forecast to rise by 3.5%, following a decrease of similar magnitude in 2016. While private investment is expected to continue growing steadily, public investment is likely to rise again following its earlier contraction.

As external demand improves further, net exports are forecast to provide a mildly positive contribution to GDP growth in 2017, and are likely to be tempered by the import-boosting revival of investment. In 2018, GDP growth is forecast to reach 2.7%, with domestic demand remaining buoyant and the contribution from net exports narrowing towards zero. Risks to the outlook are mainly linked to the uncertainty surrounding public investment projects and the timing of EU funds absorption.

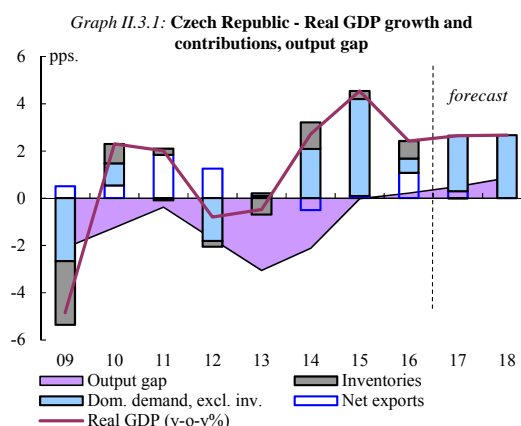
Inflation is back on track

Inflation is forecast at 2.5% in 2017, up from 0.6% in 2016, representing a structural break following three years of barely positive inflation rates. The HICP rate continued to surprise on the upside at 2.5% in the first quarter of 2017, propelled by strong price rises for fresh food. Inflation is expected to moderate somewhat this year and next, and is forecast to average 2.0% over 2018. The main contributions to inflation are expected from services prices, propped up by a tightening labour market. Food prices are expected to show only limited increase but should continue to contribute

positively to inflation over the forecast horizon. Administered prices are forecast to have a negligible contribution in 2017.

Free-floating of Czech koruna after more than 3 years

The Czech National Bank removed the koruna floor versus the euro on 6 April 2017. Market reactions so far have been limited to a minimal appreciation of the koruna, which in itself would have a limited impact on the economy in the short term. As the policy change was widely anticipated, economic agents – such as exporting firms – are expected to have prepared for the event and hedged their exposure to currency risk. Nonetheless the new exchange rate regime increases uncertainty.



Labour market nearing its limits

Employment growth is forecast to slow to 0.3% in 2017 and eventually 0% in 2018. The slowdown from 1.8% in 2016 is driven by demographic constraints, as the population of working age is expected to shrink slightly in both years. The unemployment rate is forecast to decrease only marginally, from 4% in 2016 to 3.5% in both 2017 and 2018. The number of vacancies has remained high and there are reports of skill shortages. Hence, it is possible that employment and

unemployment levels have reached or are close to their limit. The tight labour market is likely to support further wage growth acceleration. Nominal wages per employee are forecast to grow by more than 4.5% in 2017 and 2018, amid higher pay rises to some professions in the public sector.

Government balance to remain positive

The general government balance turned positive in 2016, reaching 0.6% of GDP, an improvement of more than 1 pp. compared to 2015. This surplus was underpinned by a robust tax intake, with revenues from both direct and indirect taxes recording growth of more than 5%. A fall in public investment of 33% year-on-year further contributed to the surplus. The investment drop took place from a particularly high level of EU co-financed investment in 2015, coupled with a sluggish roll-out of investment projects at the beginning of the new programming period in 2016.

The headline balance surplus is forecast to decline to 0.3% of GDP in 2017. This reflects the effect of a rebound of co-financing for EU-funded projects. The expenditure side is negatively impacted by a

slight increase in pensions in line with rising inflation. Interest expenditure is forecast to continue decreasing, albeit less markedly than in 2016. Tax revenues are expected to be bolstered by the phasing-in of anti-tax evasion measures on the other hand, but lowered by declining, excise duties on mineral oils and on tobacco products.

On the back of an increase in social outlays the headline government balance is expected to narrow slightly to 0.1% of GDP in 2018. This is partially offset on the revenue side, which is supported by tax-rich growth in the context of a positive macroeconomic outlook.

The structural balance is estimated to have improved by 1¼ pps. in 2016. A structural worsening throughout 2017 and 2018 is expected to lead to a structural balance of around -¼% of GDP by the end of the forecast horizon. The debt-to-GDP ratio declined to 37.2% in 2016, which was supported by solid economic growth and a fiscal surplus. General government debt is forecast to remain on a firm downward path, declining to 36.2% of GDP in 2017 and 35.6% in 2018.

Table II.3.1:

Main features of country forecast - CZECH REPUBLIC

	2015		97-12	Annual percentage change						
	bn CZK	Curr. prices		% GDP	2013	2014	2015	2016	2017	2018
GDP	4554.6		100.0	2.3	-0.5	2.7	4.5	2.4	2.6	2.7
Private Consumption	2139.7		47.0	2.1	0.5	1.8	3.0	2.9	2.4	2.6
Public Consumption	889.7		19.5	1.3	2.5	1.1	2.0	1.2	2.0	1.9
Gross fixed capital formation	1198.1		26.3	1.7	-2.5	3.9	9.0	-3.7	3.5	4.2
of which: equipment	542.3		11.9	3.6	0.3	6.4	8.5	-3.1	3.6	4.5
Exports (goods and services)	3778.3		83.0	9.2	0.2	8.7	7.7	4.3	4.5	4.8
Imports (goods and services)	3499.1		76.8	8.2	0.1	10.1	8.2	3.2	4.5	5.2
GNI (GDP deflator)	4255.2		93.4	2.0	-0.2	1.9	4.7	3.1	2.7	2.7
Contribution to GDP growth:										
Domestic demand				1.8	0.1	2.1	4.1	0.6	2.3	2.7
Inventories				-0.1	-0.7	1.1	0.3	0.7	0.0	0.0
Net exports				0.6	0.1	-0.5	0.1	1.1	0.3	0.0
Employment				-0.1	0.3	0.6	1.4	1.8	0.3	0.0
Unemployment rate (a)				7.0	7.0	6.1	5.1	4.0	3.5	3.5
Compensation of employees / head				5.7	-0.3	2.6	2.6	3.9	4.6	4.6
Unit labour costs whole economy				3.2	0.5	0.4	-0.5	3.3	2.2	1.9
Real unit labour cost				0.4	-0.9	-2.0	-1.5	2.2	0.5	0.2
Saving rate of households (b)				11.5	10.9	11.8	11.8	12.1	11.7	11.5
GDP deflator				2.8	1.4	2.5	1.0	1.1	1.6	1.7
Harmonised index of consumer prices				3.2	1.4	0.4	0.3	0.6	2.5	2.0
Terms of trade goods				-0.2	1.5	1.8	0.5	0.9	-0.6	0.0
Trade balance (goods) (c)				-2.6	4.1	5.1	4.5	5.3	5.0	4.8
Current-account balance (c)				-3.9	-1.1	-1.2	-1.2	0.3	0.0	-0.2
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-3.2	1.1	0.5	1.9	0.8	0.5	0.3
General government balance (c)				-3.8	-1.2	-1.9	-0.6	0.6	0.3	0.1
Cyclically-adjusted budget balance (d)				-4.0	0.1	-1.0	-0.6	0.5	0.0	-0.2
Structural budget balance (d)				-	0.2	-0.8	-0.6	0.5	0.0	-0.2
General government gross debt (c)				27.0	44.9	42.2	40.3	37.2	36.2	35.6

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.